

Stayton Cooperative Telephone Company and Subsidiaries

Consolidated Financial Statements
with Supplemental Information

Years Ended December 31, 2016 and 2015



STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors
Stayton Cooperative Telephone Company and Subsidiaries
Stayton, Oregon

We have audited the accompanying consolidated financial statements of Stayton Cooperative Telephone Company (an Oregon cooperative corporation) and Subsidiaries (the Company), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive income, changes in members' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Stayton Cooperative Telephone Company and Subsidiaries as of December 31, 2016 and 2015, and the results of its operations and cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Report on Consolidating Information

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The consolidating information in Schedules I - III are presented for the purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies, and it is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The consolidating financial information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and certain additional procedures, including comparing and reconciling information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with auditing standards generally accepted in the United States of America. In our opinion, the consolidating information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Aldrich CPAs + Advisors LLP

Salem, Oregon
March 3, 2017

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES**Consolidated Balance Sheets**

December 31, 2016 and 2015

ASSETS	<u>2016</u>	<u>2015</u>
Current Assets:		
Cash and cash equivalents	\$ 5,512,886	\$ 4,409,550
Marketable securities	904,451	895,182
Accounts receivable, less allowance for doubtful accounts of \$5,000 in 2016 and 2015	1,270,420	1,194,301
Current portion of notes receivable	18,741	17,741
Materials and supplies	605,083	715,017
Income taxes receivable	430,250	-
Prepaid expenses	374,609	374,518
Total Current Assets	<u>9,116,440</u>	<u>7,606,309</u>
Other Assets and Investments:		
Nonutility property	409,036	465,565
Notes receivable	154,945	173,550
Other investments	1,062,017	1,245,141
Deferred income taxes	166,300	451,248
Other assets	1,118,463	1,188,063
Total Other Assets and Investments	<u>2,910,761</u>	<u>3,523,567</u>
Property, Plant, and Equipment:		
Telecommunications	64,323,172	61,152,551
Under construction	-	2,991
Total Property, Plant, and Equipment	64,323,172	61,155,542
Less accumulated depreciation	<u>36,037,961</u>	<u>32,857,958</u>
Property, Plant, and Equipment, net	<u>28,285,211</u>	<u>28,297,584</u>
Total Assets	<u>\$ 40,312,412</u>	<u>\$ 39,427,460</u>

LIABILITIES AND MEMBERS' EQUITY	<u>2016</u>	<u>2015</u>
Current Liabilities:		
Current portion of long-term debt	\$ 937,500	\$ 937,500
Accounts payable	189,526	247,392
Patronage capital payable	356,401	362,814
Accrued expenses	503,719	301,471
Advanced billing	429,310	424,570
Income taxes payable	-	20,000
Total Current Liabilities	<u>2,416,456</u>	<u>2,293,747</u>
Long-Term Liabilities:		
Other long-term liabilities	950,489	987,662
Long-term debt	937,500	1,875,000
Deferred credits	<u>968,329</u>	<u>1,041,780</u>
Total Long-Term Liabilities	<u>2,856,318</u>	<u>3,904,442</u>
Members' Equity:		
Memberships	27,044	26,887
Patronage capital	31,745,183	30,513,074
Permanent capital	3,226,051	2,684,582
Accumulated other comprehensive income	<u>41,360</u>	<u>4,728</u>
Total Members' Equity	<u>35,039,638</u>	<u>33,229,271</u>
Total Liabilities and Members' Equity	<u>\$ 40,312,412</u>	<u>\$ 39,427,460</u>

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES**Consolidated Statements of Operations**

Years Ended December 31, 2016 and 2015

	2016	2015
Operating Revenues:		
Local network	\$ 1,563,386	\$ 1,550,488
Network access	9,183,644	9,496,525
Internet	546,339	108,843
Long distance	257,714	252,953
Other operating – regulated	293,633	353,733
Other operating – nonregulated	338,774	255,941
Total Operating Revenues	12,183,490	12,018,483
Operating Expenses:		
Plant specific	1,315,121	1,268,698
Plant nonspecific	792,554	845,298
Customer	736,334	738,036
General and administrative	1,767,449	1,816,762
Depreciation and amortization	3,685,501	3,492,866
Internet	727,765	962,774
Long distance	110,031	108,509
Other operating – nonregulated	517,445	474,014
Other taxes	408,800	403,033
Income tax provision	262,980	491,538
Total Operating Expenses	10,323,980	10,601,528
Operating Margin	1,859,510	1,416,955
Other Income and Expenses, net	112,450	54,841
Margin Available for Fixed Charges	1,971,960	1,471,796
Fixed Charges, Interest on Long-Term Debt	126,184	180,078
Net Margin	\$ 1,845,776	\$ 1,291,718

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES**Consolidated Statements of Comprehensive Income**Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Net Margin	\$ <u>1,845,776</u>	\$ <u>1,291,718</u>
Other Comprehensive Income:		
Unrealized gain (loss) on marketable securities	56,512	(23,995)
Reclassification adjustment for losses realized, net of tax	2,725	12,358
Deferred tax asset (liability) on unrealized gain (loss)	<u>(22,605)</u>	<u>9,598</u>
Total Other Comprehensive Income (Loss)	<u>36,632</u>	<u>(2,039)</u>
Total Comprehensive Income	\$ <u><u>1,882,408</u></u>	\$ <u><u>1,289,679</u></u>

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Consolidated Statements of Changes in Members' Equity

Years Ended December 31, 2016 and 2015

	Member- ships	Patronage Capital	Permanent Capital	Accumulated Other Comprehensive Income	Total
Balance, December 31, 2014	\$ 26,718	\$ 30,628,070	\$ 2,023,929	\$ 6,767	\$ 32,685,484
Redemption of patronage capital	-	(769,689)	6,502	-	(763,187)
Decrease in other comprehensive income, net of income taxes	-	-	-	(2,039)	(2,039)
Excise tax refund	-	17,126	-	-	17,126
Other changes in memberships, patronage and permanent capital	169	42,930	(42,930)	-	169
Net margin	-	594,637	697,081	-	1,291,718
Balance, December 31, 2015	26,887	30,513,074	2,684,582	4,728	33,229,271
Redemption of patronage capital	-	(91,498)	6,028	-	(85,470)
Increase in other comprehensive income, net of income taxes	-	-	-	36,632	36,632
Excise tax refund	-	13,272	-	-	13,272
Other changes in memberships, patronage and permanent capital	157	-	-	-	157
Net margin	-	1,310,335	535,441	-	1,845,776
Balance, December 31, 2016	<u>\$ 27,044</u>	<u>\$ 31,745,183</u>	<u>\$ 3,226,051</u>	<u>\$ 41,360</u>	<u>\$ 35,039,638</u>

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES**Consolidated Statements of Cash Flows**

Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Cash Flows from Operating Activities:		
Net margin	\$ 1,845,776	\$ 1,291,718
Adjustments to reconcile net margin to net cash provided by operating activities:		
Depreciation and amortization	3,685,501	3,492,866
Nonutility depreciation	75,839	83,037
Gain on investments and marketable securities	(34,681)	(21,330)
Change in other assets	69,600	2,360
Change in deferred credits	(73,451)	(94,378)
Change in deferred income taxes	260,600	(54,255)
Changes in assets and liabilities:		
Accounts receivable	(76,119)	402,382
Materials and supplies	109,934	54,481
Income tax receivable	(450,250)	-
Prepaid expenses	(91)	34,390
Accounts payable	(57,866)	(66,976)
Accrued expenses	202,248	(206,552)
Advanced billings	4,740	1,583
Other long-term liabilities	(37,173)	1,278
Income tax payable	<u>-</u>	<u>20,000</u>
Net Cash Provided by Operating Activities	<u>5,524,607</u>	<u>4,940,604</u>
Cash Flows from Investing Activities:		
Collection of note receivable	17,605	107,602
Purchase of property, plant, and equipment	(3,692,437)	(3,862,762)
Proceeds from sale of investments and marketable securities	474,631	239,634
Purchase of investments and marketable securities	(230,879)	(666,495)
Patronage dividends received	<u>25,763</u>	<u>33,531</u>
Net Cash Used by Investing Activities	<u>\$ (3,405,317)</u>	<u>\$ (4,148,490)</u>

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES**Consolidated Statements of Cash Flows, continued**

Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Cash Flows from Financing Activities:		
Payments on long-term debt	\$ (937,500)	\$ (937,500)
Payments of capital credits, net	(91,883)	(524,750)
Net change in membership	157	169
Excise tax refunds	<u>13,272</u>	<u>17,126</u>
Net Cash Used by Financing Activities	<u>(1,015,954)</u>	<u>(1,444,955)</u>
 Net Increase (Decrease) in Cash and Cash Equivalents	1,103,336	(652,841)
 Cash and Cash Equivalents, beginning	<u>4,409,550</u>	<u>5,062,391</u>
Cash and Cash Equivalents, ending	\$ <u><u>5,512,886</u></u>	\$ <u><u>4,409,550</u></u>
 Cash Paid During the Year for Interest, net of amount capitalized	\$ <u><u>120,004</u></u>	\$ <u><u>74,514</u></u>
Cash Paid for Income Taxes	\$ <u><u>452,630</u></u>	\$ <u><u>438,998</u></u>

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Note 1 - Organization and Summary of Significant Accounting Policies

Organization

Stayton Cooperative Telephone Company (SCTC or the Company) is an Oregon cooperative corporation providing telecommunications, broadband, and related services within and around the City of Stayton, Oregon. The wholly owned subsidiary, SCS Communications & Security, Inc. (SCS) offers telecommunications and broadband services as a competitive local exchange carrier (CLEC) within and around the City of Aumsville, Oregon. People's Telephone Company (PTC), a wholly owned subsidiary of SCS, is an Oregon corporation providing telecommunication and broadband services within and around the City of Lyons, Oregon.

Basis of Consolidation

The consolidated financial statements include the accounts of SCTC and its wholly owned subsidiaries, SCS and PTC. Intercompany balances and transactions have been eliminated in consolidation.

Basis of Accounting

The Company's financial statements are prepared on the accrual basis of accounting in conformity with the accounting principles generally accepted in the United States of America applicable to regulated enterprises.

Regulation

The Company is subject to limited regulation by the Public Utility Commission of Oregon (PUC) and the Federal Communications Commission (FCC). The Company maintains its accounting records in accordance with the Uniform System of Accounts, as prescribed by the FCC, and adopted by the PUC. As a result, the Company's application of accounting principles generally accepted in the United States of America differs in certain respects from the application by non-regulated entities. Such differences primarily concern the time at which certain items enter into the determination of net margin.

Regulatory and legislative actions, as well as future regulations, could have a significant impact on the Company's future operations and financial condition. See Note 1, National Broadband Plan and FCC Order.

Estimates

The Company uses estimates and assumptions in preparing consolidated financial statements in accordance with accounting principles generally accepted in the United States of America. Those estimates and assumptions affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities, and the reported revenues and expenses. Actual results could differ from these estimates.

Comprehensive Income

The Company reports comprehensive income. The purpose of reporting comprehensive income is to report all changes in members' equity of an enterprise that result from recognized transactions and other economic events of the period other than transactions with members in their capacity as members.

Income Taxes

The Company has been granted an exemption from Federal income taxes under Section 501(c)(12) of the Internal Revenue Code, except for "unrelated" business income. The Company is also exempt from state income taxes. However, in any year for which greater than 15% of gross revenue is derived from nonmember services, the Company becomes a taxable cooperative. Federal and state taxes payable by taxable cooperatives are computed differently from taxes payable by other corporations, primarily because cooperatives are allowed to deduct margins allocated to patrons within 8 1/2 months after the end of each taxable year. SCS and PTC are taxable corporations (see Note 8).

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Note 1 - Organization and Summary of Significant Accounting Policies, continued

Income Taxes, continued

The Company follows accounting standards generally accepted in the United States of America related to the recognition of uncertain tax positions. The Company recognizes accrued interest and penalties associated with uncertain tax positions as part of the income tax provision, when applicable. There were no amounts accrued in the consolidated financial statements related to uncertain tax positions.

Revenue Recognition

The Company recognizes revenues when earned regardless of the period in which they are billed.

Monthly service fees derived from local telephone and broadband service are billed in advance. Advance billings are recorded as a liability and subsequently transferred to income in the period earned. Access charges (see Note 1, Network Access Revenue), long distance, and other revenues based on usage are billed in arrears.

Cash and Cash Equivalents

The Company considers all highly liquid investment securities with a maturity of 3 months or less to be cash equivalents. The Company maintains its cash and cash equivalents in bank deposit accounts that are insured by the Federal Deposit Insurance Corporation (FDIC) up to a limit of \$250,000 per depositor per bank. At December 31, 2016 the Company had uninsured cash of \$4,995,747 (\$3,914,247 at December 31, 2015).

The Company has not experienced any losses in such accounts and believes it is not exposed to any significant credit risk on cash.

Marketable Securities

The Company has classified all marketable securities as available for sale. These investments are stated at fair value in the consolidated financial statements with accumulated unrealized gains and losses reported as a separate component of members' equity.

Accounts Receivable

The Company extends credit to its customers. An allowance for doubtful accounts is maintained, based upon management's review of the year-end accounts receivable aging and past credit and collections history. Receivables are written off when the Company determines an account is uncollectible. Past due status is determined based on the age of the past due account.

Fair Value of Financial Instruments

The Company's financial instruments, none of which are held for trading purposes, include cash and cash equivalents, marketable securities, receivables, accounts payable, and notes payable. The Company estimates that the fair value of all of these non-derivative financial instruments, at December 31, 2016 and 2015 does not differ materially from the aggregate carrying value of its financial instruments recorded in the accompanying consolidated balance sheets.

Materials and Supplies

Materials and supplies are stated at the lower of cost or market. Cost is determined principally by the average cost method.

Nonutility Property

Nonutility property consists of video and internet equipment in service stated at cost. The Company provides for depreciation on a straight-line basis over estimated useful lives of 5 to 30 years. Maintenance, repairs, and replacements are charged to expense as incurred. When property or equipment are sold or otherwise disposed of, the asset account and the related accumulated depreciation accounts are relieved, and any gain or loss is included in operations.

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Note 1 - Organization and Summary of Significant Accounting Policies, continued

Investments

Investments in which the Company holds a 20%-50% interest are accounted for on the equity method. Investments accounted for on the equity method are recorded at cost and adjusted for the Company's share of income or loss. Investments in which the Company holds less than a 20% interest are recorded at cost and income is recorded when dividends are received.

Property, Plant, and Equipment

Telecommunications plant in service and under construction is stated at cost, including estimated overhead expense. Depreciation is calculated on a straight-line basis over the estimated life of the classes of buildings and equipment in accordance with rates consistent with industry standards. Depreciation rates range from 2% to 20%. In accordance with composite group depreciation methodology and industry practice, when a portion of the Company's property, plant, and equipment is retired in the ordinary course of business, the gross book value, plus removal expenses, less salvage, is charged to accumulated depreciation and no gain or loss is recognized.

The Company follows the policy of capitalizing interest as a component of the cost of property, plant, and equipment constructed for its own use. In 2016, total interest incurred was \$126,184 (\$180,078 in 2015) of which \$19,826 (\$11,710 in 2015) was capitalized.

Patronage Allocations

The net operating margin of the Company plus federal excise tax refunds are allocated to its members annually, in proportion to the member's annual charges for eligible services. Nonoperating margins, including subsidiary margins, are allocated or retained by the Company at the discretion of its Board of Directors. Any indebtedness owed by a member and not paid within 60 days may be offset on a discounted basis by the Company against a member's patronage account. The net present value is determined using a discount rate commensurate with the Company's current borrowing rate.

Network Access Revenues

Network access revenue is received under a system of access charges. Access charges represent a methodology by which local telephone companies, including the Company, charge the long-distance carrier for access and interconnection to local facilities. The Company has elected to file access tariffs through the National Exchange Carriers Association (NECA) and directly with the PUC for these charges. These access tariffs are subject to approval by the FCC for interstate charges and the PUC for intrastate charges.

When network access revenues have been received pursuant to the settlement and access agreements above, they are then either placed into a common pooling arrangement with other exchange carriers for redistribution or kept by the Company. The redistributions are made according to formulas established by the governing boards of the pools and are generally based upon expenses incurred and investments maintained.

SCTC and PTC participate in various pooling arrangements with NECA.

Settlement, access, and pool distribution revenues are recorded when the amounts become determinable. Related expenses are recorded when incurred. Subsequent true-ups and retroactive adjustments, which are generally allowed for a period of 24 months, are recorded in the year in which such adjustments become determinable, based upon studies prepared by outside consultants.

In addition to recoveries from the pools, SCTC and PTC also receive revenues from the Universal Service High Cost Loop Fund (HCL) which includes Safety Net Additive (SNA) and other support mechanisms administered by the Universal Service Administrative Company (USAC). These universal service support revenues are intended to compensate the Company for the high cost of providing service in rural areas.

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Note 1 - Organization and Summary of Significant Accounting Policies, continued

Network Access Revenues, continued

The amount of support received from HCL is based on the number of customers served and the cost of providing service in that area being in excess of the national average cost per loop, as determined by the FCC. See National Broadband Plan and FCC Order below for further information related to reforms to these support mechanisms. These support revenues are included in the network access revenues in the accompanying consolidated financial statements.

In 2016, SCTC and PTC received \$2,025,722 (\$2,155,087 in 2015) from the USAC High Cost Loop Fund, \$185,744 from SNA (\$188,869 in 2015) and \$5,512,660 (\$5,650,061 in 2015) in interstate access revenues administered through the NECA Pools.

The Company also receives funding from state universal service funds. In 2016, SCTC and PTC received \$853,434 from the Oregon Universal Service Fund (\$900,612 in 2015). Funding levels for the Oregon Universal Service Fund were determined in accordance with PUC Order 13-162. In March 2016, the PUC issued order 16-093 related to OUSF. The order is for a 5 year term beginning January 1, 2017 and calls for annual reductions to the OUSF that will result in an overall reduction of not less than 15.2% over the 5 year term for rural companies. In addition rural companies will be subject to a re-allocation process over the term of the order but no company can have its support reduced by more than 20% over this period as a result of this process. The full impact of the order cannot be determined at this time.

National Broadband Plan and FCC Order

In 2010, the FCC issued the National Broadband Plan which outlined a long-term plan to increase broadband penetrations and services throughout the United States of America.

In 2011, as an initial response to the plan, the FCC approved Report and Order 11-161 (the Order), that began the process of reforming the universal service and Intercarrier Compensation (ICC) systems and adopts support for broadband-capable networks as an express universal service principle. The Order further created the Connect America Fund (CAF) which will ultimately replace all existing high-cost support mechanisms and help facilitate ICC reforms.

The key provisions of the Order include capping the federal universal service fund (USF), placing limitations on capital and operating expenditures (subsequently eliminated in 2014 by an Order for Reconsideration issued by the FCC), establishing local rate benchmarks, capping monthly USF at \$250 per line, 5% annual reduction of local switching support to be replaced by the CAF to recover costs of switching services, a 9 year transition from the previous ICC system to bill and keep, and adoption of the Access Recovery Charge (ARC) to mitigate impacts of reduced ICC revenues. Implementation of this transition began July 1, 2012.

In 2016, the FCC issued Order 16-33, which provided the option for a voluntary election by rate-of-return carriers to receive model-based support under the Alternative Connect America Cost Model (A-CAM). On November 1, 2016, the Company did not elect to receive model based support under A-CAM. Carriers not electing A-CAM will continue to receive support based on their costs, however these legacy support mechanisms will be modified by Order 16-33. The main changes for carriers remaining on legacy support are as follows:

- Interstate Common Line Support (ICLS) will be transitioned to the CAF – Broadband Line Support (CAF-BLS), which will now provide support for voice and voice – data lines, as well as broadband only lines. Additionally, the fund for CAF-BLS will be limited to \$2 billion.
- The prescribed rate of return will be reduced by 0.25% annually starting July 1, 2016, effectively reducing the rate of return from 11.25% to 9.75% as of July 2021.
- Carriers will have broadband deployment obligations based on their current availability of 10/1 mbps broadband service in applicable study areas.

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Note 1 - Organization and Summary of Significant Accounting Policies, continued

National Broadband Plan and FCC Order, continued

- Support will be phased out in census blocks with 85% or more of competitive overlap by unsubsidized competitors offering 10/1 mbps broadband. Lost support will be phased out over 3 to 6 years depending on the severity of lost support.
- Regression calculations will be used to limit capital and operating expenditures on a prospective basis.

The Company continues to monitor various effects and requirements of the Orders noted above. As of December 31, 2016 the Company meets the local rate benchmark requirements of the Order and is not subject to the \$250 per line support cap. Furthermore, for the period ended December 31, 2016 the impacts to the Company related to the 5% annual decline in switched access revenues, and the .25% reduction of the prescribed rate of return have not been significant.

The overall reform process will continue to take place in phases and will take several more years to implement. Furthermore, it is anticipated that the FCC will continue to issue Further Notices of Proposed Rulemaking and/or Orders for Reconsideration and continue to seek comments on various items. As a result, the ultimate outcome of these proceedings and their impact is uncertain at this time.

Subsequent Events

The Company has evaluated subsequent events through March 3, 2017, which is the date the consolidated financial statements were available to be issued.

Note 2 - Marketable Securities

As mentioned in Note 1, at December 31, 2016 and 2015, all marketable securities have been categorized as available for sale and are stated at fair value in the consolidated financial statements, with unrealized gains and losses included in comprehensive income as a separate component of members' equity.

The Company has adopted a hierarchal disclosure framework, which among other matters requires enhanced disclosure about investments that are measured and reported at fair value. This framework prioritizes and ranks the level of market price observability used in measuring investments at fair value. The Company's marketable securities are measured and reported at fair value on a recurring basis based on quoted prices available in active markets for identical investments as of the reporting date (Classification Level 1). There have been no changes to the methodologies used at December 31, 2016 and 2015.

At December 31 the Company's securities are as follows:

	<u>2016</u>	<u>2015</u>
Fair value		
US treasury securities	\$ 41,158	\$ 105,360
Corporate bonds	131,797	123,204
Asset backed securities	88,732	74,965
Mutual funds	<u>642,764</u>	<u>591,653</u>
Total fair value	904,451	895,182
Cost	<u>835,591</u>	<u>887,302</u>
Gross unrealized holding gains	\$ <u>68,860</u>	\$ <u>7,880</u>

Gross unrealized holding gains are included in other comprehensive income, net of deferred taxes of \$27,500 in 2016 (\$3,152 in 2015). Proceeds from the sale of marketable securities for the year ended December 31, 2016 were \$285,912 (\$239,634 in 2015) resulting in a gross realized gain of \$4,542 for the year ended December 31, 2016 (\$20,597 loss for the year ended December 31, 2015).

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Note 2 - Marketable Securities, continued

The following is a summary of maturities of available for sale debt securities as of December 31, 2016:

	<u>Fair Value</u>	<u>Cost</u>
After one year through five years	\$ 116,990	\$ 116,592
After five years through ten years	144,697	146,575

Note 3 - Notes Receivable

During 2014, the Company issued a 5.5% note receivable to CSI Digital, Inc. in the amount of \$213,750 as part of the sale of nonutility property, which is receivable in a minimum monthly installment of \$2,319 including interest, due in August 2024.

	<u>2016</u>	<u>2015</u>
Total notes receivable	\$ 173,686	\$ 191,291
Less current portion	<u>18,741</u>	<u>17,741</u>
Notes receivable, net of current portion	\$ <u>154,945</u>	\$ <u>173,550</u>

Note 4 - Nonutility Property

Nonutility property consists of the following:

	<u>2016</u>	<u>2015</u>
Land	\$ 127,292	\$ 127,292
Buildings	156,998	156,998
Equipment and towers	<u>897,531</u>	<u>878,221</u>
Total nonutility property	1,181,821	1,162,511
Less accumulated depreciation	<u>772,785</u>	<u>696,946</u>
Nonutility property, net	\$ <u>409,036</u>	\$ <u>465,565</u>

Note 5 - Other Investments

Other investments, at cost, consist of the following:

	<u>2016</u>	<u>2015</u>
PEAK Internet, LLC	\$ 250,000	\$ 250,000
ANPI Holdings, Inc.	93,855	281,356
CHR Solutions, Inc.	135,435	135,435
Other investments	<u>202,894</u>	<u>193,685</u>
Total, at cost	\$ <u>682,184</u>	\$ <u>860,476</u>

During 2016, the controlling interest of ANPI Holdings, Inc. was sold and they began the process of redeeming the preferred stock. As of December 31, 2016 75% of the preferred stock has been redeemed and the Company received proceeds of \$187,501 from their investment in preferred stock. The remaining preferred stock in ANPI Holdings, Inc. is expected to be redeemed during 2017.

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Note 5 - Other Investments, continued

Other investments, equity method, consist of the following:

	<u>2016</u>	<u>2015</u>
Wilcom, LLC	\$ 294,833	\$ 299,665
Consolidated Business Services, LLC	<u>85,000</u>	<u>85,000</u>
Equity Investments	\$ <u>379,833</u>	\$ <u>384,665</u>
Total Other Investments	\$ <u>1,062,017</u>	\$ <u>1,245,141</u>

During the year ended December 31, 2016, the Company recorded an investment loss from Wilcom, LLC of \$4,832 (loss of \$4,825 and contributions of \$5,000 recorded in 2015).

Effective September 1, 2012 the Company, along with two other telecommunication companies, formed Consolidated Business Services, LLC to consolidate various administrative functions. Services currently being provided to the companies include accounting, regulatory reporting, management services and human resources. All three companies have a one-third ownership interest and any net income or loss will be distributed evenly to each company. The Company accounts for the investment using the equity method of accounting whereby the investment is recorded at cost and adjusted for the Company's share of income or loss. For the years ended December 31, 2016 and 2015, the Company did not contribute any additional amounts and no income or loss was allocated.

Note 6 - Other Assets

Other assets consist of the following:

	<u>2016</u>	<u>2015</u>
Deferred compensation assets	\$ 928,513	\$ 1,004,355
Life insurance - cash surrender value	<u>189,950</u>	<u>183,708</u>
	\$ <u>1,118,463</u>	\$ <u>1,188,063</u>

Deferred compensation assets represent amounts to be used for payment of deferred credits.

Cash surrender value is from life insurance policies on certain key individuals of the Company of which the Company is the beneficiary.

Note 7 - Property, Plant, and Equipment

Listed below are the major classes of telecommunications property, plant, and equipment in service:

	<u>2016</u>	<u>2015</u>
Land and support	\$ 7,384,534	\$ 7,279,886
Central office	14,540,557	13,916,490
Cable and wire facilities	<u>42,398,081</u>	<u>39,956,175</u>
	\$ <u>64,323,172</u>	\$ <u>61,152,551</u>

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Note 8 - Income Taxes

For the years ended December 31, 2016 and 2015, SCTC was taxable because it derived more than 15% of its gross revenues from nonmember services (see Note 1). SCTC files a consolidated income tax return with SCS and PTC.

Deferred income tax assets and liabilities are computed annually for differences between the consolidated financial statements and tax basis of assets and liabilities that will result in taxable or deductible amounts in the future based on enacted tax laws and rates applicable to the periods in which the differences are expected to affect taxable income. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable or refundable for the period, plus or minus the change in deferred tax assets and liabilities during the period.

Deferred taxes consist of the following:

	<u>2016</u>	<u>2015</u>
Long-term deferred income tax asset (liability):		
Noncurrent deferred tax asset	\$ 379,500	\$ 527,100
Long-term deferred income tax liability	(185,700)	(72,700)
Unrealized holding loss (Note 2)	(27,500)	(3,152)
Net long-term deferred income tax asset	\$ <u>166,300</u>	\$ <u>451,248</u>

Noncurrent deferred tax assets result from losses on investments not deductible for income tax purposes. Long-term deferred income tax liabilities result from using accelerated depreciation for income tax reporting and straight-line for financial statement reporting.

Operating income tax consists of the following:

	<u>2016</u>	<u>2015</u>
Current	\$ 2,380	\$ 544,438
Deferred provision	<u>260,600</u>	(52,900)
Operating income tax	\$ <u>262,980</u>	\$ <u>491,538</u>

Note 9 - Other Income and Expenses

Other income and expenses consists of the following:

	<u>2016</u>	<u>2015</u>
Interest and dividend income	\$ 116,829	\$ 114,467
Gain (loss) on investments and other assets (Notes 2 and 5)	21,993	(31,000)
Miscellaneous expense	(26,372)	(28,626)
Total other income, net	\$ <u>112,450</u>	\$ <u>54,841</u>

Note 10 - Employee Benefit Plans

Pension Plans

The Company has adopted a retirement plan in accordance with Internal Revenue Code Section 401(k). The Company makes a 3% safe harbor contribution, 3.5% profit sharing contribution, plus a dollar for dollar match of up to 4% each month. Contributions are based on each eligible participant's compensation. The Company is allowed to make additional discretionary contributions. Contributions for the year ended December 31, 2016 were \$192,935 (\$215,774 in 2015).

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Notes to Consolidated Financial Statements

Years Ended December 31, 2016 and 2015

Note 10 - Employee Benefit Plans, continued

Deferred Compensation Plan

The Company has entered into nonqualified deferred compensation agreements with certain key employees. The agreements provide for payment of monthly benefits upon retirement provided certain conditions are met. The estimated amounts to be paid for these agreements are being accrued over the period of active employment. The net present value of the outstanding liability for deferred compensation is included in deferred credits within the consolidated balance sheet.

Post-retirement Health Benefits

Employees age 55 or older with a hire date before October 9, 2007 who have completed 15 years of service with the Company are eligible to receive post-retirement health benefits. The Company will pay the health and dental insurance premiums for these retirees until the earlier of age 65 or when they become eligible to receive Medicare benefits. The cost of providing these benefits is accrued over the period of active employment. At December 31, 2016, the amount accrued for post-retirement benefits is \$950,489 (\$987,662 at December 31, 2015) and is unfunded. The net periodic benefit cost incurred in 2016 was \$29,241 (\$32,233 in 2015). For the year ended December 31, 2016, the amount of benefits paid under post-retirement health benefits was \$62,159 (\$73,593 in 2015). No significant changes in the benefits paid is anticipated.

Note 11 - Long-Term Debt

Long-term debt consists of the following:

	<u>2016</u>	<u>2015</u>
Note payable to CoBank, at 5.05%, payable in quarterly installments, principal and interest, collateralized by all real and personal property, due in 2018.	\$ 1,875,000	\$ 2,812,500
Less current portion	(<u>937,500</u>)	(<u>937,500</u>)
	\$ <u>937,500</u>	\$ <u>1,875,000</u>

Future maturities of long-term debt are as follows:

2017	\$ 937,500
2018	<u>937,500</u>
	\$ <u>1,875,000</u>

The Company's long-term debt agreement with CoBank contains certain restrictions and covenants. In addition, the Company must maintain certain financial ratios (debt service coverage, total debt to EBITDA, equity to total assets). Management believes the Company to be in compliance with these covenants at December 31, 2016 and 2015.

Note 12 - Related Parties

The Company has an agreement with PEAK Internet, LLC which provides IT management and customer support. Amounts billed to the Company in 2016 were \$329,181 (\$382,410 in 2015).

The Company entered into an agreement with Consolidated Business Services, LLC (CBS, LLC) in 2012 (see Note 5) whereby CBS, LLC will provide accounting and regulatory reporting services for the Company. CBS, LLC provided services to the Company in the amount of \$358,527 in 2016 (\$409,455 in 2015). At December 31, 2016, there was \$26,340 payable to CBS, LLC for labor and expenses (\$34,513 was payable to CBS, LLC at December 31, 2015).

SUPPLEMENTAL INFORMATION

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Consolidating Balance Sheets

December 31, 2016

ASSETS	<u>SCS</u>	<u>PTC</u>	<u>SCTC</u>	<u>Eliminations</u>	<u>Consolidated</u>
Current Assets:					
Cash and cash equivalents	\$ 44,366	\$ 720,653	\$ 4,747,867	\$ -	\$ 5,512,886
Marketable securities	-	-	904,451	-	904,451
Accounts receivable, less allowance for doubtful accounts of \$5,000	8,167	281,129	1,221,078	(239,954)	1,270,420
Current portion of notes receivable	-	-	18,741	-	18,741
Materials and supplies	-	-	605,083	-	605,083
Intercompany taxes receivable	77,000	(170,600)	93,600	-	-
Income taxes receivable	-	-	430,250	-	430,250
Prepaid expenses	1,531	36,636	336,442	-	374,609
Total Current Assets	<u>131,064</u>	<u>867,818</u>	<u>8,357,512</u>	<u>(239,954)</u>	<u>9,116,440</u>
Other Assets and Investments:					
Nonutility property	-	113,681	295,355	-	409,036
Note receivable	-	-	154,945	-	154,945
Other investments	-	-	1,062,017	-	1,062,017
Investment in subsidiary	7,641,655	-	8,299,539	(15,941,194)	-
Deferred income taxes	310,500	(116,700)	(27,500)	-	166,300
Other assets	928,513	-	189,950	-	1,118,463
Total Other Assets and Investments	<u>8,880,668</u>	<u>(3,019)</u>	<u>9,974,306</u>	<u>(15,941,194)</u>	<u>2,910,761</u>
Property, Plant, and Equipment:					
Telecommunications	719,378	13,396,532	50,207,262	-	64,323,172
Less accumulated depreciation	<u>440,365</u>	<u>6,290,556</u>	<u>29,307,040</u>	<u>-</u>	<u>36,037,961</u>
Property, Plant, and Equipment, net	<u>279,013</u>	<u>7,105,976</u>	<u>20,900,222</u>	<u>-</u>	<u>28,285,211</u>
Total Assets	<u>\$ 9,290,745</u>	<u>\$ 7,970,775</u>	<u>\$ 39,232,040</u>	<u>\$ (16,181,148)</u>	<u>\$ 40,312,412</u>

LIABILITIES AND MEMBERS' EQUITY	SCS	PTC	SCTC	Eliminations	Consolidated
Current Liabilities:					
Current portion of long-term debt	\$ -	\$ -	\$ 937,500	\$ -	\$ 937,500
Accounts payable	13,438	236,111	179,931	(239,954)	189,526
Patronage capital payable	-	-	356,401	-	356,401
Accrued expenses	-	26,982	476,737	-	503,719
Advanced billing	9,439	66,027	353,844	-	429,310
Total Current Liabilities	<u>22,877</u>	<u>329,120</u>	<u>2,304,413</u>	<u>(239,954)</u>	<u>2,416,456</u>
Long-Term Liabilities					
Other long-term liabilities	-	-	950,489	-	950,489
Long-term debt	-	-	937,500	-	937,500
Deferred credits	<u>968,329</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>968,329</u>
Total Long-Term Liabilities	<u>968,329</u>	<u>-</u>	<u>1,887,989</u>	<u>-</u>	<u>2,856,318</u>
Members' Equity:					
Memberships	-	-	27,044	-	27,044
Patronage capital	-	-	31,745,183	-	31,745,183
Permanent capital	-	-	3,226,051	-	3,226,051
Other equity	8,299,539	7,641,655	-	(15,941,194)	-
Accumulated other comprehensive income	<u>-</u>	<u>-</u>	<u>41,360</u>	<u>-</u>	<u>41,360</u>
Total Members' Equity	<u>8,299,539</u>	<u>7,641,655</u>	<u>35,039,638</u>	<u>(15,941,194)</u>	<u>35,039,638</u>
Total Liabilities and Members' Equity	<u>\$ 9,290,745</u>	<u>\$ 7,970,775</u>	<u>\$ 39,232,040</u>	<u>\$ (16,181,148)</u>	<u>\$ 40,312,412</u>

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Consolidating Statements of Operations

Year Ended December 31, 2016

Schedule II

	<u>SCS</u>	<u>PTC</u>	<u>SCTC</u>	<u>Eliminations</u>	<u>Consolidated</u>
Operating Revenues:					
Local network	\$ 60,751	\$ 226,410	\$ 1,281,366	\$ (5,141)	\$ 1,563,386
Network access	6,156	2,271,376	7,169,745	(263,633)	9,183,644
Internet	-	-	1,877,662	(1,331,323)	546,339
Long distance	-	-	260,747	(3,033)	257,714
Other operating – regulated	4,911	60,964	354,487	(126,729)	293,633
Other operating – nonregulated	-	-	339,797	(1,023)	338,774
Total Operating Revenues	<u>71,818</u>	<u>2,558,750</u>	<u>11,283,804</u>	<u>(1,730,882)</u>	<u>12,183,490</u>
Operating Expenses:					
Plant specific	20,235	248,109	1,053,742	(6,965)	1,315,121
Plant nonspecific	17,494	127,872	647,188	-	792,554
Customer	15,776	108,399	612,425	(266)	736,334
General and administrative	83,072	413,399	1,280,818	(9,840)	1,767,449
Depreciation and amortization	37,296	623,878	3,024,327	-	3,685,501
Internet	-	-	2,326,744	(1,598,979)	727,765
Long distance	-	-	221,936	(111,905)	110,031
Other operating – nonregulated	-	-	520,372	(2,927)	517,445
Other taxes	-	66,301	342,499	-	408,800
Income tax provision	(37,200)	391,400	(91,220)	-	262,980
Total Operating Expenses	<u>136,673</u>	<u>1,979,358</u>	<u>9,938,831</u>	<u>(1,730,882)</u>	<u>10,323,980</u>
Operating Margin (Loss)	(64,855)	579,392	1,344,973	-	1,859,510
Other Income and Expenses, net	<u>600,296</u>	<u>20,019</u>	<u>626,987</u>	<u>(1,134,852)</u>	<u>112,450</u>
Margin Available for Fixed Charges	535,441	599,411	1,971,960	(1,134,852)	1,971,960
Fixed Charges, Interest on Long-Term Debt	-	-	126,184	-	126,184
Net Margin	<u>\$ 535,441</u>	<u>\$ 599,411</u>	<u>\$ 1,845,776</u>	<u>\$ (1,134,852)</u>	<u>\$ 1,845,776</u>

STAYTON COOPERATIVE TELEPHONE COMPANY AND SUBSIDIARIES

Consolidating Statements of Cash Flows

Year Ended December 31, 2016

	<u>SCS</u>	<u>PTC</u>	<u>SCTC</u>	<u>Eliminations</u>	<u>Consolidated</u>
Cash Flows from Operating Activities:					
Net margin	\$ 535,441	\$ 599,411	\$ 1,845,776	\$ (1,134,852)	\$ 1,845,776
Adjustments to reconcile net margin to net cash provided (used) by operating activities:					
Depreciation and amortization	37,296	623,878	3,024,327	-	3,685,501
Nonutility depreciation	-	7,299	68,540	-	75,839
Income from affiliated companies	(599,411)	-	(535,441)	1,134,852	-
Gain on investments and marketable securities	-	-	(34,681)	-	(34,681)
Change in other assets	75,842	-	(6,242)	-	69,600
Change in deferred credits	(73,451)	-	-	-	(73,451)
Change in deferred income taxes	39,800	220,800	-	-	260,600
Changes in assets and liabilities:					
Accounts receivable	(744)	19,185	(16,022)	(78,538)	(76,119)
Materials and supplies	-	-	109,934	-	109,934
Intercompany taxes	(31,500)	(404,100)	435,600	-	-
Income taxes receivable	-	-	(450,250)	-	(450,250)
Prepaid expenses	184	74	(349)	-	(91)
Accounts payable	(4,876)	(73,102)	(58,426)	78,538	(57,866)
Accrued expenses	-	3,174	199,074	-	202,248
Advanced billing	(81)	(91)	4,912	-	4,740
Other long-term liabilities	-	-	(37,173)	-	(37,173)
Net Cash Provided (Used) by Operating Activities	<u>(21,500)</u>	<u>996,528</u>	<u>4,549,579</u>	<u>-</u>	<u>5,524,607</u>
Cash Flows from Investing Activities:					
Collection of notes receivable	-	-	17,605	-	17,605
Purchase of property, plant, and equipment	(2,953)	(1,434,371)	(2,255,113)	-	(3,692,437)
Proceeds from sale of investments and marketable securities	-	-	474,631	-	474,631
Purchase of investments and marketable securities	-	-	(230,879)	-	(230,879)
Patronage dividends received	-	-	25,763	-	25,763
Net Cash Used by Investing Activities	<u>\$ (2,953)</u>	<u>\$ (1,434,371)</u>	<u>\$ (1,967,993)</u>	<u>\$ -</u>	<u>\$ (3,405,317)</u>

	<u>SCS</u>	<u>PTC</u>	<u>SCTC</u>	<u>Eliminations</u>	<u>Consolidated</u>
Cash Flows from Financing Activities:					
Payments on long-term debt	\$ -	\$ -	\$ (937,500)	\$ -	\$ (937,500)
Payments of capital credits, net	-	-	(91,883)	-	(91,883)
Net change in membership	-	-	157	-	157
Excise tax refunds	-	-	13,272	-	13,272
Net Cash Used by Financing Activities	-	-	(1,015,954)	-	(1,015,954)
Net Increase (Decrease) in Cash and Cash Equivalents	(24,453)	(437,843)	1,565,632	-	1,103,336
Cash and Cash Equivalents, beginning	68,819	1,158,496	3,182,235	-	4,409,550
Cash and Cash Equivalents, ending	<u>\$ 44,366</u>	<u>\$ 720,653</u>	<u>\$ 4,747,867</u>	<u>\$ -</u>	<u>\$ 5,512,886</u>
Cash Paid During the Year for Interest, net of amount capitalized	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 120,004</u>	<u>\$ -</u>	<u>\$ 120,004</u>
Cash Paid During the Year for Income Taxes	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 452,630</u>	<u>\$ -</u>	<u>\$ 452,630</u>